

regularly share their views and experiences relating to fraud prevention and detection in the context of fraudulent financial reporting. The Committee received testimony that it would improve audit quality and benefit the capital markets and investors and other financial statement users for auditing firms to share their fraud detection experiences<sup>81</sup> and to develop best practices relating to fraud prevention and detection.<sup>82</sup>

The Committee believes that a collective sharing of fraud prevention and detection experiences among auditors and other market participants will provide a broad view of auditor practices and ultimately improve fraud prevention and detection capabilities and enable the development of best practices. The Committee also believes that research into industry trends and statistics will help auditors focus and develop procedures to identify areas and situations at greater risk for fraud. The Committee believes that best practices regarding fraud prevention and detection will enhance the internal processes and procedures of auditing firms.

The Committee recommends the creation of a national center both to facilitate auditing firms' sharing of fraud prevention and detection experiences, practices, and data and innovation in fraud prevention and detection methodologies and technologies and to commission research and other fact-finding regarding fraud prevention and detection. The Committee also recommends that the auditing firms, forensic accounting firms, certified fraud examiners, investors, other financial statement users, public companies, and academics develop, in consultation with the PCAOB, the Securities and Exchange Commission (SEC), international regulators, and the National Association of State Boards of Accountancy (NASBA), best practices regarding fraud prevention and detection. The Committee also recognizes that a national center and best practices will have greater impact if these concepts are ultimately extended and embraced internationally.

(b) Urge that the PCAOB and the SEC clarify in the auditor's report the auditor's role in detecting fraud under current auditing standards and further that the PCAOB periodically review and update these standards.

The Committee considered testimony and commentary regarding a long-standing

"expectations gap" between the public's expectations regarding auditor responsibility for fraud detection and the auditor's required and capable performance of fraud detection.<sup>83</sup> The public may believe that auditors will detect more fraud than those in the profession believe can be reasonably expected. This belief may be unreasonable in some circumstances given the difficulties of detecting fraud, especially before it has resulted in a material misstatement. On the other hand, public investors have raised questions when large frauds have gone undetected. The auditing standard governing fraud detection, AU Section 316, *Consideration of Fraud in a Financial Statement Audit*, notes that fraud may involve deliberate concealment and collusion with third parties.<sup>84</sup> AU Section 316 states that the "auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud." This gap between public expectation and the auditor's performance causes confusion and ultimately undermines investor confidence in financial reporting and the capital markets.

Commentary has suggested that auditors must more effectively communicate their responsibility regarding fraud detection and prevention with investors and the capital markets. The Committee agrees with this suggestion. Accordingly, the Committee believes that the auditor's report should articulate clearly to investors the auditor's

<sup>83</sup> See, e.g., Andrew D. Bailey, Jr., Professor of Accountancy—Emeritus, University of Illinois, and Senior Policy Advisor, Grant Thornton LLP, Comment Letter Regarding Discussion Outline 4 (Jan. 30, 2008), available at [http://comments.treas.gov/\\_files/BAILEYCOMMENTS/ONTREASURYADVISORYCOMMITTEE/OUTLINEFINALSUBMISSION13008.doc](http://comments.treas.gov/_files/BAILEYCOMMENTS/ONTREASURYADVISORYCOMMITTEE/OUTLINEFINALSUBMISSION13008.doc) (stating that "[i]f the discovery of material errors and fraud is not a major part of what the audit is about, it is not clear what value-added service the auditor offers the investor and capital markets"); Record of Proceedings (Feb. 4, 2008) (Questions for the Record of Cynthia M. Fornelli, Executive Director, Center for Audit Quality, 5 (Mar. 31, 2008)), available at <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-2-4-08.pdf> ("While auditors provide reasonable assurance that fraud material to the financial statements will be detected, they cannot be expected to provide absolute assurance that all material fraud will be found. Cost-benefit constraints and the lack of governmental subpoena and investigative powers, among other factors, make absolute assurance impossible."); Record of Proceedings (Feb. 4, 2008) (Written Submission of Dennis Johnson, California Public Employees' Retirement System, 5), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Johnson020408.pdf> (stating that "[o]f critical importance to investors is the responsibility of auditors to detect fraud and improve the timely communication of these frauds to investors and shareowners."); Serving Global Capital Markets and the Global Economy: A View from the CEOs of the International Audit Networks 12 (Nov. 2006) ("Nonetheless, there is a significant 'expectations gap' between what various stakeholders believe auditors should do in detecting fraud, and what audit networks are actually capable of doing, at the prices that companies or investors are willing to pay for audits.").

<sup>84</sup> Consideration of Fraud in a Financial Statement, Interim Auditing Standard AU 316 (Pub. Company Accounting Oversight Bd. 2002).

role and limitations in detecting fraud. The Committee believes that expressly communicating to investors, other financial statement users, and the public the role of auditors in fraud detection would help narrow the "expectations gap."

The Committee recommends that the PCAOB and the SEC clarify in the auditor's report the auditor's role and limitations in detecting fraud under current auditing standards. In addition, the Committee recommends, in light of this continuing "expectations gap," that the PCAOB review the auditing standards governing fraud detection and fraud reporting. Specifically, the Committee recommends that the PCAOB periodically review and update these standards.

Recommendation 2. Encourage greater regulatory cooperation and oversight of the public company auditing profession to improve the quality of the audit process and enhance confidence in the auditing profession and financial reporting.

The SEC, the PCAOB, and individual state boards of accountancy regulate the auditing profession. The SEC and the PCAOB enforce the securities laws and regulations addressing public company audits. Individual state accountancy laws in 55 jurisdictions in the United States govern the licensing and regulation of both individuals and firms who practice as certified public accountants.<sup>85</sup> State boards of accountancy enforce these laws and also administer the Uniform CPA Examination. NASBA serves as a forum for these boards to enhance their regulatory effectiveness and communication.

The Committee believes that enhancing regulatory cooperation and reducing duplicative oversight of the auditing profession by federal and state authorities and enhancing licensee practice mobility among the states are in the best interest of the public and the effective operation of the capital markets. In this regard, the Committee recommends the following:

(a) Institute the following mechanism to encourage the states to substantially adopt the mobility provisions of the Uniform Accountancy Act, Fifth Edition (UAA);<sup>86</sup> If states have failed to adopt the mobility provisions of the UAA by December 31, 2010, Congress should pass a federal provision requiring the adoption of these provisions.

The American Institute of Certified Public Accountants (AICPA) and NASBA jointly author the UAA, a model bill which focuses on the education, examination, and experience requirements for certified public accountants. As the name of the bill suggests, the UAA advances the goal of uniformity, in addition to protecting the public interest and promoting high professional standards. In 2006 and 2007, recognizing the changing global economy and the impact of electronic commerce, the AICPA and NASBA proposed amendments to the UAA to allow for a streamlined framework for CPA "mobility" of

<sup>85</sup> Record of Proceedings (Dec. 3, 2007) (Written Submission of David A. Costello, President and Chief Executive Officer, National Association of State Boards of Accountancy, 2), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Costello120307.pdf>.

<sup>86</sup> Uniform Accountancy Act (Fifth Ed. July 2007).

<sup>81</sup> See, e.g., Record of Proceedings (Feb. 4, 2008) (Questions for the Record of Cynthia M. Fornelli, Executive Director, Center for Audit Quality, 6 (Mar. 31, 2008)), available at <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-2-4-08.pdf>; Record of Proceedings (Dec. 3, 2007) (Written Submission of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, 7), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Turley120307.pdf>.

<sup>82</sup> See, e.g., Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 10), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Nusbaum020408.pdf> (stating that "[s]uccess also requires that the profession work with standard setters and regulators to develop best practices and the infrastructure for effective audits designed to detect material financial fraud").